9/24/87 R9050-3A

TAX FOUNDATION'S **50th Anniversary Year** VOL. 31, NO. 5 JULY/AUGUST 1987

TAX·FEATURES

Recent Gains in Disposable Income Fail To Offset Long-Term Erosion by Taxes, Inflation

Shadow Committee Addresses Current Stalemate over Budget

Tax Foundation's Shadow Committee on the Federal Budget states in a newly released report that Congress and the President must avert a new upward spiral in deficits by agreeing "on a package of spending cutbacks and revenue increases that lowers the deficit, not only in the fiscal 1988 year, but for several years ahead."

In revising the Gramm-Rudman-Hollings process, the Congress should keep in mind that "the key to responsible deficit reduction is to use targets that ensure that each year's defict is lower as a percentage of the Gross National Product and also lower than the pervious year's deficit level."

The full report is available from the Tax Foundation at a cost of $4.00 plus $1.00 postage/handling.

Total Government Spending Soars, Doubles in 8 Years to $1.76 Trillion

Spending by all government units in the United States has more than doubled since 1979 and will reach an estimated $1.76 trillion in fiscal year 1987, acccording to Tax Foundation analysts.

The country will accordingly witness its seventh year of trillion-dollar government budgets. (Some may recall that the nation's total output of goods and services – public and private – did not reach the trillion-dollar level until 1970.)

This year's spending by Federal, state, and local jurisdictions will amount to $7,271 per capita, up from $3,726 in 1979. Per household, that comes to $19,660 for each of the nation's 89 million households, as compared to $10,764 eight years ago.

The growth rate of government spending since 1979 has far outpaced the growth in the nation's total output, or gross national product (GNP).

Public spending, measured on a calendar year basis and within the framework of the national income and product accounts, increased at a rate one-third higher than concurrent growth in GNP. In 1979 government spending accounted for less than 31 percent of GNP; in 1987 government's share is more

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Slowing of inflation and Federal tax cuts have boosted the U.S. family's purchasing power since 1981, according to Tax Foundation analysts. Despite these gains, the prototypical family — one earner who is married with two dependent children and is employed full-time year round earning $28,230 before taxes — is worse off today than it was ten years ago, with $2,010 less purchasing power.

Measured in constant 1987 dollars, the family's real income after direct Federal taxes has increased by $1,242 (5.6 percent) since 1981. This contrasts dramatically with the preceding four years, when the family's purchasing power dropped $3,252 in 1987 dollars.

Between 1977 and 1981, inflation and rising Federal taxes eroded nearly 13 percent from the buying power of this prototypical family. This period saw increases in Federal income and social security taxes on this family average more than 11 percent annually, while inflation rose at a rate of nearly 11 percent a year. Even though the family's nominal income grew by nearly 8 percent annually, higher increases in taxes and inflation cut deep into real purchasing power.

In sharp contrast, Federal direct taxes between 1981 and 1987 have risen just over 4 percent annually, and inflation has slowed to an average of less than 4

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Median Family Income Before and After Direct Federal Taxes and Inflation, 1977 – 1987

Year	Median Family Income[a]	Direct Federal Taxes: Income Tax[b]	Direct Federal Taxes: Social Security	Direct Federal Taxes: Total	After-tax Income: Current Dollars	After-tax Income: 1987 Dollars[c]
1977	15,949	1,466	933	2,399	13,550	25,518
1978	17,318	1,717	1,048	2,765	14,553	25,442
1979	19,048	1,881	1,168	3,049	15,999	25,116
1980	20,586	2,143	1,262	3,405	17,181	23,763
1981	21,462	2,267	1,427	3,694	17,768	22,266
1982	23,036	2,342	1,543	3,885	19,151	22,610
1983	23,943	2,277	1,604	3,881	20,062	22,954
1984	25,415	2,395	1,703	4,098	21,317	23,374
1985	25,992	2,466	1,832	4,298	21,694	23,005
1986[d]	27,144	2,865	1,941	4,806	22,338	23,220
1987[d]	28,230	2,704	2,018	4,722	23,508	23,508

[a] Median income for all families with one earner employed full-time, year-round.
[b] Married couple filing joint return, two dependent children.
[c] Adjusted by Consumer Price Index of the Bureau of Labor Statistics. Assumes 4% inflation in 1987.
[d] Estimated by Tax Foundation.

Sources: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; Treasury Department, Internal Revenue Service.

How Federal, State, and Local Governments Raise All that Money . . .

Individual income taxes were the largest single source of revenue for U.S. governments in 1985 (latest reported), accounting for 28.3 cents of every dollar raised by Federal, state, and local governments, according to Tax Foundation economists.

More than $401 billion of the $1.418 trillion that governments collected in 1985 came from individual income taxes.

Social security payroll taxes were the second major revenue source, raising 16.7 cents of every revenue dollar, or nearly $237 billion in 1985. Following were current charges, 9.6 cents; miscellaneous general revenue (e.g., interest earnings and sales of government property), 7.8 cents; property taxes levied by state and local governments, 7.3 cents; selective sales and excise taxes, 6.4 cents; general sales taxes, 5.9 cents; corporate income taxes, 5.7 cents; and miscellaneous taxes (death and gift, motor vehicle and operators' licenses, unemployment compensation, and others, 4.6 cents per dollar of total revenue.

Individual income taxes have held the top position as a revenue producer since World War II. In 1985 they provided just slightly more of the revenue dollar than they had 25 years earlier, 28.3 cents compared with 28.2 cents in 1960. Their share of the total, however, is down slightly from 30.3 cents in 1970 and 30.7 cents in 1980. The relative decline in the role of individual income taxes reflects two main factors, according to Tax Foundation analysts. One is

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How Federal, State, and Local Governments Raise Each Dollar of Public Funds Selected Fiscal Years 1960-1985

Source	Cents per dollar of total revenue 1960	1970	1980	1985
Tax revenues	82.7	82.4	78.2	74.9
Individual income	28.2	30.3	30.7	28.3
Social Security (OASDHI)	7.0	11.5	15.0	16.7
Property	10.7	10.2	7.3	7.3
Selective sales and excises	12.5	9.8	6.5	6.4
Corporate income	14.8	11.0	8.4	5.7
General sales	3.5	4.8	5.5	5.9
Other taxes (a)	6.0	4.8	4.8	4.6
Nontax revenues	17.3	17.6	21.8	25.1
Current charges	8.1	7.9	8.6	9.6
Miscellaneous general revenue(b)	3.3	4.0	6.7	7.8
Employee retirement	1.9	2.5	3.1	4.1
Utilities and liquor stores	3.2	2.6	2.7	3.1
Other nontaxes	.8	.6	.7	.5
Exhibit (billions):				
Total revenues	$153.1	$333.8	$932.2	$1,418.4
Surplus (+) or deficit (-)	+$1.8	+$.8	-$26.5	-$162.7

(a) Includes death and gift, motor vehicle and operators' licenses, unemployment compensation, and miscellaneous taxes.
(b) Includes interest earnings, special assessments, sale of property, and others.
Sources: *Facts and Figures on Government Finance*, 1986, Tax Foundation, and other data from U.S. Department of Commerce, Bureau of the Census.

. . . . And How They Spend It All

How Federal, State, and Local Governments Spend Each Dollar of Public Funds Selected Fiscal Years 1960-1985

Function	Cents per dollar of total spending 1960	1970	1980	1985
Major social welfare programs, total	20.6	25.8	33.6	31.9
Social Security (OASDHI)	7.1	10.8	15.6	16.0
Social services and income maintenance (a)	8.5	10.7	13.0	11.4
Government employee retirement	1.4	1.9	3.0	3.0
Veterans (not elsewhere classified)	2.5	1.6	1.3	1.1
Railroad retirement	.6	.5	.5	.4
National defense and international relations	32.3	25.3	15.6	18.3
Education	12.8	16.7	15.0	13.0
Interest on general debt	6.2	5.5	7.9	10.9
Environment and housing	5.4	4.4	4.9	5.7
Utilities and liquor stores	3.4	2.8	3.8	3.8
Transportation	7.6	6.2	4.4	3.6
Public safety	1.8	2.0	2.3	3.2
Government administration	1.8	1.9	2.2	2.3
Postal service (Federal)	2.5	2.3	1.9	1.8
Sanitation	1.1	1.0	1.4	1.1
All other	4.5	6.1	7.0	4.4
Exhibit (billions):				
Total spending	$151.3	$333.0	$958.7	$1,581.1

(a) Comprises public welfare, hospitals, health, and unemployment insurance benefits.
Sources: *Facts and Figures on Government Finance*, 1986, Tax Foundation; and other data from U.S. Department of Commerce, Bureau of the Census.

Social welfare programs consumed 31.9 cents of every government dollar spent in 1985 (latest reported). Nearly one-third of all 1985 public expenditures, some $504 billion out of total spending by all levels of government of $1,581 billion, went to support the social welfare network.

National defense and international relations was the second highest at 18.3 cents per dollar. Education expenditures ranked third, taking 13.0 cents per dollar; interest costs ranked fourth at 10.9 cents; and environment and housing followed at 5.7 cents.

Federal social security (OASDHI) led the field, claiming 16.0 cents of every dollar spent by all levels of government. Social welfare programs also include social services and income maintenance (public welfare, health and hospitals, and unemployment insurance), which accounted for 11.4 cents per dollar of government spending. Other programs included are government employee retirement, railroad retirement, and veterans' programs not elsewhere classified—4.5 cents.

Even these large

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Tax Features

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A Decade of Deficits; Generations of Debt

When the budgetary history of the 1980s is written, two words—deficits and debt—will sum up the failure of the federal government to manage the nation's finances in a responsible manner. This has been a decade of record deficits and of a truly massive escalation in the public debt of the United States. The budget deficit has exceeded $100 billion in every fiscal year since 1982; it has been about $200 billion in three of the past four fiscal years. This tide of red ink has left the federal government owing more than ever before. When the decade started, the public debt was less than one trillion dollars; when it ends, the debt will be more than three trillion dollars. Each American's "share" of the public debt is about $10,000—more than two thirds of per capita income.

When the budgetary history of the 1980s is written, two words—deficits and debt—will sum up the failure of the federal government to manage the nation's finances in a responsible manner.

How did we get into this mess? What does it portend for the future financial health of the United States? Can anything be done about it? At this stage, it is easier to explain what went awry than to devise acceptable solutions; nevertheless, steps can be taken to prevent matters from getting much worse.

Why We Borrowed So Much

Looking back at recent deficits, there is enough blame to go around. The President persuaded Congress to cut income tax rates at the same time he was campaigning for more defense spending. Congress slowed the growth in domestic expenditures, but it did little to control the steep rise in transfer payments and other entitlements. For the past five years, the White House and Congress have been locked in a budgetary stalemate which has impeded deficit reduction. The Gramm-Rudman-Hollings (GRH) process has helped a bit, but much less than promised. In the 1986-88 period, actual deficits will total more than $100 billion above the GRH targets. Both branches have used accounting tricks to make the deficit appear lower than it actually is. By substituting for real savings, these gimmicks have allowed the public debt to continue its upward spiral.

Economic conditions, interest costs, and the way in which the debt is financed have also contributed to the explosion of debt.

Weak economic growth. The economy has been growing about 2 percent a year in the 1980s, only about half the growth rate in the 1950s and 1960s and below the growth in the troubled 1970s. Growth in this decade has generally been below the level assumed in the budget; as a consequence, deficits have been above budgeted levels. In effect, the Federal government is spending as if the economy were producing 4 percent real growth a year.

Interest payments. Deficits beget deficits, as each year's added borrowing burdens the government with more interest to pay. Net interest has soared from $52 billion in 1980 to about $140 billion in the current fiscal year. One out of every seven dollars in the budget now goes to pay interest on the public debt. If it were free of these interest charges, the budget would almost be balanced.

Financing the debt. The government finances a sizeable portion of the deficit by borrowing from the social security fund and other trust funds. If these trust funds were excluded, the actual deficit would be tens of billions of dollars above the amount reported in the unified budget. One consequence of this financing method is that the debt increase is greater than the deficit. During the 1980s, the increase in the debt is likely to be about $500 billion more than the decade's cumulative budget deficit.

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Why the Size of the Debt Matters

It has become fashionable in recent years to downplay the size of the public debt. A 1986 book by economist Robert Eisner, *How Real is the Federal Deficit?*, argues that the debt would be a lot smaller if adjustments were made for inflation and changes in the government's capital assets. Unfortunately, however, capital markets deal with actual numbers, not with arbitrary adjustments. Moreover, the steepest rise in the debt has occurred during a period of declining inflation.

To understand the dangers latent in the government's huge debt, it is essential to keep in mind that, unlike states and localities which actually pay off maturing debt, the Federal government almost always rolls over its indebtedness. There are two critical implications of this practice: (1) Every additional billion dollars borrowed in 1987 will mean additional billions of dollars of debt down the road. Over a long span the government will pay many billions of dollars in interest charges for each additional billion dollars of debt. (2) If there are adverse market conditions and high interest rates when the government borrows, these affect not only the new funds it seeks to raise but the refinancing of old debt as well.

The following are a number of other problems associated with the massive debt.

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(DECADE OF DEFICITS, *from page 3*)

The ratio of debt to GNP. As long as the economy is growing fast, some rise in the debt may not indicate financial difficulty. The table at right shows that the ratio of debt to GNP fell steadily from 96% in 1950 to only 34% in 1980. Since then, however, this ratio has soared more than 20 percentage points. In 1980, each dollar of debt was backed by three dollars of gross national product; today, it is supported by less than two dollars of GNP. While the debt/GNP ratio is still well below early postwar levels, the recent indebtedness has been incurred in peacetime.

Foreign indebtedness. As the debt has grown, so too has the amount borrowed abroad. The amount of public debt held by foreigners has soared from $122 billion in 1980 to $256 billion in 1986. In 1986 alone, the Federal government borrowed almost $50 billion from foreign residents. Private borrowing abroad has also increased sharply. This dependence on foreign lenders adversely affects Americans in two ways: first, interest on foreign-held debt represents the transfer of wealth from the United States to other countries; second, the government is increasingly dependent on the willingness of foreigners to lend us money. When Japanese participation in Treasury financing slackened earlier this year, interest rates soared.

Rigid budgets. Rising interest charges have contributed to increased rigidity in Federal expenditures. These charges and mandatory entitlements now account for close to two-thirds of total Federal spending. There can be little doubt that the interest burden has impeded the government's capacity to respond to changing priorities.

Easing the Debt Crisis

Recent economic performance demonstrates that the Federal government cannot grow out of big deficits. The country is now in the fifth consecutive year of economic expansion, but the 1987 deficit will probably be $50 billion above the level in 1982, the last recession year.

Controlling the deficit is the key to stabilizing the debt burden. It requires both short-term and long-term actions. The immediate need is to lower the debt/GNP ratio and the percentage of outlays allocated to interest payments. The deficit-reduction path laid out by the Gramm-Rudman-Hollings law would accomplish this objective, but the GRH targets have not been met thus far, and it is doubtful whether they can be met in the years ahead without significant changes in budget policies.

With the recovery in its fifth year, the possibility of a recession in the not-too-distant future cannot be dismissed. If the economy slips, the deficit and debt will be propelled upward. One of the lessons of the 1980s is that one year's cyclical deficit rapidly becomes the next year's structural deficit. Care must be taken, therefore, to control the deficit before the economy turns sluggish.

The problem could be aggravated in the longer term due to the fact mentioned earlier that much of the debt is financed by borrowing from social security and other funds. As the social security trust fund builds up gargantuan surpluses—exceeding one trillion dollars by the end of the century—the Federal government will have a convenient source of "in-house" borrowed funds. But when the balances in the social security fund are drawn down in the 21st century to pay retirement benefits to the baby boomers, the overall annual deficit might greatly surpass anything experienced thus far. If we wait until that happens, it will be too late to take corrective action. One way of preparing for this problem is to establish GRH-type targets for the "Federal funds" deficit, that is, to exclude social security and (possibly) other trust funds from each year's required deficit reduction.

The decade of deficits and debt is nearing an end, but its legacy will be borne by many generations to come. Now is the time to control the damage; if we don't, a poorer country will pay a frightful price for our failures.

Federal Debt and Interest Payments
Selected Fiscal Years, 1950-1990
($ billions)

Year	Debt* Total	Debt* %GNP	Deficit	Net Interest Total	Net Interest %Outlays
1950	$ 256.9	96.3%	$ 3.1	$ 4.8	11.3%
1960	290.9	57.4	+0.3	6.9	7.5
1970	382.6	38.6	2.8	14.4	7.4
1980	914.3	34.2	73.8	52.5	8.9
1985	1,827.4	46.4	212.3	129.4	13.7
1987**	2,372.4	53.7	173.2	137.5	13.5
1988**	2,585.5	55.1	107.8	139.0	13.6
1990**	2,991.3		59.5		

* End of fiscal year
** Office of Management and Budget projections

Federal, State, and Local Government Expenditures[a]
Selected Fiscal Years 1950–1987

Fiscal year	Billions of dollars: All gov'ts	Federal	State and local	Dollars: Per household	Per capita
1950	$ 70.3	$ 44.8	$ 25.5	$ 1,614	$ 466
1960	151.3	97.3	54.0	2,866	847
1965	205.7	130.1	75.6	3,581	1,067
1970	333.0	208.2	124.8	5,252	1,643
1975	560.1	340.5	219.6	7,875	2,612
1980	958.6	615.4	343.2	11,867	4,243
1981	1,109.8	717.4	392.4	13,474	4,857
1982	1,233.5	794.7	438.8	14,768	5,345
1983	1,351.0	872.5	478.5	16,099	5,798
1984	1,428.0	926.5	501.6	16,720	6,056
1985	1,581.1	1,030.2	550.9	18,217	6,644
1986[b]	1,675.6	1,077.9	597.7	18,943	6,972
1987[b]	1,763.5	1,106.0	657.5	19,660	7,271

[a] Grants-in-aid are counted as expenditures of the first disbursing unit.
[b] Estimated by Tax Foundation.
Sources: Basic data from U.S. Department of Commerce, Bureau of the Census; computations by Tax Foundation.

(TOTAL GOVERNMENT SPENDING, *from page 1*)

than 35 percent of total GNP. Expressed in other terms the *increase* in public spending since 1979 is equal to nearly 41 percent of the *increase* in overall GNP in the past eight years.

But in the last two years, Tax Foundation analysts say, the growth of government has been slowing. Spending is expected to rise by an annual average of under 6 percent in the years 1985–1987, as compared to average yearly increases of 10.5 percent in the first half of the 1980s and 11.1 percent during the 1970s. In fiscal 1987 alone, public spending will rise by an estimated $88 billion, or 5.2 percent—a modest percentage gain by recent standards. The slowing reflects restraints in the growth of Federal outlays, attributable largely to the efforts of Congress and the Administration to pare bulging Federal budget deficits.

Tax Foundation economists estimate that Federal spending will go up by just 2.6 percent in 1987, the smallest annual increase in more than a decade. In contast, between 1980 and 1985, Federal spending grew by 10.0 percent a

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JULY/AUGUST 1987

Capital Gains Taxation: '86 Changes Are 'Anti-People'

By C. Lowell Harriss

The capital gains provisions of the Tax Reform Act of 1986 (TRA '86) are "anti-people" in the sense that they seek to transfer personal capital to government—mainly for consumption rather than investment. And consuming capital reduces the base for production of goods for the public. TRA '86 also cuts the after-tax rewards for the risk-taking that contributes to human progress.

Major Change

The new rule is that realized capital gains will be taxed in full as ordinary income. Losses will be deductible against realized gains but still not against ordinary income in excess of $3,000. Other provisions curtail or eliminate various arrangements, sometimes rather artificial, that were used to convert ordinary income into capital gains for tax purposes.

The new treatment of capital gains will have many complex and unexpected effects. One thing is quite certain, however. The effective tax rate that now applies will generally be 28 percent, as against an average rate in the recent past which was well below the maximum rate of 20 percent. Add on state taxes, and, for many, the overall tax on capital gains now will approach one third, often more than doubling the total burden.

Such an outcome contradicts the promise of lower rates and fairer tax burdens which drove the tax reform movement in its early stages.

Consuming Capital

Capital has a crucial rule in human progress. One should think of a unit of capital, if maintained, as adding permanently to the flow of production and income. This truth, the productive worth of capital, has been established over a long history. The beneficiaries of investment are people—in our capacities as workers, consumers, and investors. Capital is one part of the cooperative process of production for everyone, not something benefiting only the already prosperous or something to be set off as a rival to labor.

Per dollar of revenue, a tax on capital gains ranks at, or near, the top in adverse effects on capital formation and preservation. While the tax does not destroy existing machinery or utility systems or housing, it does take funds from taxpayers who thereby suffer loss of ability to finance the maintenance and improvement of the nation's capital base.

Lawmakers and the staff advisors who guided many of their policies expected the capital gains provisions of TRA '86 to increase government revenue. In effect, they planned for government to take some private capital holdings to pay for the government's current spending. Even as responsible leaders were correctly deploring the low rate of *net saving* in the United States, the framers of tax revision explicitly designed a capital *consumption* element into last year's "reform."

Quite possibly, however, there will be no net revenue gain. The higher tax rate actually may be a revenue loser. The rate increase will discourage the realizing of gains. With Federal plus state taxes absorbing one-third or so of a gain, an owner can reinvest only two-thirds of the gain. In the past he would have had more than three-fourths (usually much more) to reinvest. The added burden will in many cases tip the balance against realizing gain and paying any tax.

Tightening the Lock-In

When a property owner chooses not to realize gains because of the potential tax on the transaction, there is a "lock-in" effect. The investor will hold assets with accrued gains longer than indicated by investment criteria alone.

The production of an economy and its progress depend not only upon the total quantity of labor, capital and natural resources, but also upon the allocation of what is available. Some uses of capacity are more productive than others. The more promptly and easily resources move from the lesser to the better use—i.e., the smoother the process of allocation—the greater the productivity of the economy. The benefits spread broadly—to employees, owners of land and other natural resources, suppliers of capital, and consumers.

Unquestionably, TRA '86 increased the incentive to retain assets with gains. Holding capital involves no tax, while selling to reinvest will cost more than in the past. The accentuated bias against the redeployment of capital creates "excess burden." The economy loses through poorer resource allocation, and there is no comparable revenue growth for the Treasury. This lock-in could be reduced by extending to all capital transactions the tax-free rollover treatment now allowed for certain sales of homes. A government plagued with large deficits, however, will tend to resist changes that are perceived as reducing immediate revenue.

The Blow to Risk-Taking

The capital gains provisions of TRA '86 strike at risk-taking, a crucial element in economic progress. Some progress comes from doing more of the same, for example, construction of new housing. Much advance, however, comes from inno-

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vation, from doing the untested. Most of us know too little of history to appreciate the pioneering and venturing into the unknown, the imagination and the effort, the risking of funds and the heartbreak, all the many forms of risk that have contributed to our life. What we now take for granted was once one person's "gleam in the eye," scoffed at and ignored by others.

Persons who were successful in risky ventures—those who invested ideas and effort and those who put up the funds—could escape the full bite of income taxation. Capital gains were not taxed until realized and then at rates below those on ordinary income. Although tax offsets for losses were incomplete, persons taking risks could expect some protection from the top rates of income taxation. If successful, they could press ahead, using earnings to finance some expansion. Moreover, there was valid hope of keeping most of the gain if they sold and of passing much to heirs even after death taxes.

Recent reductions in high-bracket tax rates resulted in part from the belief that the freeing of human creativity will bring benefits to all Americans. More persons of talent and ambition, it was argued, will make greater efforts to develop new products and services and to provide expanded and more efficient production facilities. Lowering tax rates increase the rewards for successful innovation and entrepreneurship. The general public benefits. Over the years, risk-taking will be greater if after-tax rewards are more attractive.

But although personal tax rates will now be lower than at any time within the memory of most Americans, the taxes on successful venturing will be heavier. While reducing burdens on the rewards for routine work and on the fruits of conservative investment—on ordinary income—the new law increases the burdens on realized gains from successful risk-taking.

Just as TRA '86's lock-in effect will tend to reduce, not increase, revenue, so also any discouraging of entrepreneurship and innovation will tend to dampen economic growth. Over the years, the growth of the country's economic base, and of the Treasury's revenues, will be slower. As a portion of the overall economy, this factor may not be large. But any diminished potential for growth justifies concern, particularly when the loss is avoidable.

In 1978, Congress reversed course and cut the tax rate on capital gains. In doing so, it not only moderated the tax bite but also gave evidence of a new spirit, one more hospitable to business enterprise. A marked rise in the supply of venture capital followed. While the extent of causal influence cannot be precisely measured, the change was dramatic. The record is consistent with a conclusion that reducing the tax on successful risk-taking will increase the supply. TRA '86 will not choke off risk-taking, but it will discourage this vital economic tonic.

Fairness Issues

Fairness and equity considerations raise complex issues in considering the taxation of capital gains and losses. For example, lucky winnings from stock or real estate investments must constitute taxpaying capacity. Any exemptions of gains from luck alone, or taxation at rates lower than those on the ordinary income of middle-class workers and investors, must seem inequitable. So will a system that imposes tax on a person who has true capital losses that are greater than his ordinary income. The enormous variety in the differences in personal economic positions complicates the search for fairness in taxation. The taxpayer has some control over realizing gains and losses, and thus has some ability to influence the tax due.

Not everything qualifying as a capital gain in recent years has resulted from innovative, successful, creative entrepreneurship. Not all of the tax-saving devices served the economy well, certainly not well enough to deserve effective tax rates that were lower than those paid by the working person or the thrifty family on its savings account. To avoid heavy, discouraging tax burdens on risk-taking in creative enterprise, a society need not offer relatively easy ways to convert ordinary income into capital gains.

TRA '86 does reduce the differences in effective tax rates on incomes of different sizes. Provisions altering the tax structure, e.g., those affecting use of tax shelters, profoundly change the application of income taxation. Do the net results, including those from the new treatment of capital gains and losses, enhance or erode the equity of sharing the cost of government?

There are no clear guides to resolve debates on fairness. On a few points, however, there may be some agreement. There will probably be wide consensus that limiting the deduction of *losses* to capital gains and $3,000 of ordinary income a year creates unfairness. It is simply not fair to impose income tax when a person has losses greater than ordinary income. Why has this long-recognized inequity not been corrected? One reason is the desire for revenue. A second reason grows out of the taxpayer's control over realization. It is sensible to delay the realization of gains and take advantage of deductibility of losses. However, the $3,000 a year limit certainly could be increased without enabling persons with large incomes to escape all income tax.

On another point, there will also be widespread agreement. The present system is inequitable in failing to allow for inflation. The full dollar amount of a gain is taxed regardless of what has happened to the worth of the dollar while the asset was held. The owner may have had no real income, or the amount realized net of inflation may be appreciably less than the dollar figure. The dollar has lost much purchasing power in the last fifteen years. Would not everyone agree that it is unfair to tax as income a change in capital value that merely equals, or may even fall short of, the decline in the worth of the dollar?

* * * *

Substantive change of TRA '86 will come despite dislike for the thought of another round of major revision. When there is opportunity, an outstanding candidate for change to reduce obstacles to economic progress will be in the taxation of capital gains and losses.

(FAMILY PURCHASING POWER, *from page 1*)
percent a year. These developments have increased the family's purchasing power an average of .9 percent a year for the six years, even though the family's nominal income increases fell from an average of 8 percent to less than 5 percent annually. While social security taxes far outpaced nominal income growth because of increases in tax rates, Federal income taxes rose at a slower rate (3 percent a year on average) and inflation was somewhat below the rise in nominal income.

This modest improvement has not made up for what was lost during earlier years of the decade. From 1977 to 1987, while pre-tax nominal income rose 77 percent, direct Federal taxes increased by nearly 97 percent, from $2,399 to $4,722. Income taxes rose from $1,466 in 1977 to $2,704 in 1987, an increase of 84%. Social security taxes more than doubled, rising from $933 to $2,018.

Despite two major income tax reduction laws — in 1981 and 1986 — Federal personal income taxes as a share of the family's nominal income rose from 9.2 percent in 1977 to 9.6 percent in 1987. Social security taxes went up even more rapidly, from 5.85 percent of income ten years ago to 7.15 percent in 1987. This year, direct Federal taxes will claim 16.7 percent of the family's income, more than the 15.0 percent that prevailed at the beginning of the decade. The peak in taxes for the decade — 17.2 percent — occurred in 1981.

While taxes had a role in reducing the purchasing power of the family, the real culprit was inflation. For the period 1977 through 1987 the price level, as measured by the Consumer Price Index, rose more than 88 percent, making each 1977 dollar worth only 53 cents in 1987. The combination of rising prices and a growing tax bite reduced the purchasing power of the family by nearly 8 percent for the decade.

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"... And Promises to Keep"

The air of the Capital City is electric with allegations of betrayed trust this summer. As the Iran/Contra hearings grind toward their conclusion, the U.S. Congress seems to have the best of it. The Boland Amendment — or the several Boland Amendments — we are told, have been flouted by Administration officials. The clear will of the U.S. Congress has been flagrantly ignored or circumvented by individuals seeking to run their own covert foreign policy.

Congress, the courts, and, ultimately the voting public will decide the merits of the substantive issues behind "Irangate." Certainly foreign policy and intelligence operations are outside the purview of the Tax Foundation.

What is not outside our bailiwick, however, is the notion of public trust, of the ability and willingness of officials of all branches and at all levels of government to keep their promises in as much as these commitments concern fiscal policy. And even as Congress is presently fulminating at the Administration for breaking the law and violating public trust, the Congress's ethical magnifying glass seems to be highly selective.

Quick as it is to condemn the mote in the Administration's eye, Congress is equally slow to see the beam in its own. Specifically, Congress is well into its second decade of ignoring its own strictures for fiscal responsibility. More bluntly, Congress is breaking a number of its own laws. To wit:

■ In 1974, the Budget and Impoundment Control Act committed Congress to a reasonable timetable for preparing and voting expenditures. Congress has never been in full compliance with that law. Most years, it hasn't even come close.

■ In 1978, the Byrd Amendment stated baldly that, beginning in fiscal year 1981, annual budget outlays of the Federal government "shall not exceed" receipts. Congress simply ignored the Byrd Amendment.

■ In 1982, TEFRA promised $3 of cuts for every $1 of tax increase. Recent calculations indicate that we wound up with about 17 cents of cuts for every $1 of tax hikes.

■ In 1985, the Gramm-Rudman-Hollings deficit reduction act attempted to force Congress and the Administration to do what they had been incapable of doing on their own: move the Budget toward balance through a mandatory series of spending reductions over a five-year period. When the Supreme Court pulled the teeth of enforceability from GRH in early 1986, the process went down the tubes. Compliance last year was a charade. To date, this year, it is nonexistent.

Yet, every year the American taxpayer is subjected to the specious claim that another "real" tax cut has been passed and that new "real" spending cuts have been made. And every year, the budget deficit fails to shrink and, if we're lucky, at best *the rate of increase* of Federal spending programs slows.

Far be it from us to suggest that Congress abrogate its oversight of foreign policy and intelligence. What we seek is that the 100 U.S. Senators and 435 U.S. Representatives apply to the conduct of their own official responsibilities the same ethical yardstick they are so busily applying to others.

(TOTAL GOV'T SPENDING, *from page 4*)
year on average. State and local spending is expected to continue to rise at a rate of around 10 percent, similar to that experienced during the first half of the decade.

The Federal government's $1.11 trillion share of public spending in 1987 accounts for about 63 percent of the total, slightly less than in recent years, and down from 65 percent in 1985. This has not always been the case, however. Tax Foundation researchers note that Federal spending was less than 50 percent of total public spending until the mid-1930s. World War II developments catapulted that share to over 90 percent during the peak spending years.

States and localities will spend an estimated $658 billion this year from the funds they raise. (Expenditures from Federal grants-in-aid to these units are counted in the Federal total.) This will represent an increase of about $60 billion over the previous fiscal year, as compared to the estimated $28 billion rise in Federal outlays.

MARK YOUR CALENDAR

for the

Tax Foundation's

50th Anniversary
National Conference and Annual Dinner

to be held at the Waldorf-Astoria Hotel
in New York City, Wednesday, December 2.
Watch for details in future issues of Tax Features.

(COLLECTING EACH DOLLAR, *from page 2*)
the more rapid growth in social security taxes and nontax revenues. The other is the slower rise of Federal income taxes as a result of the Economic Recovery Tax Act of 1981 (ERTA). Similar effects due to the Tax Reform Act of 1986 can be expected after 1986. In part, however, the slower growth in Federal income taxes since 1980 has been modified by the rapid increase in state/local taxes. Since 1980 Federal individual income taxes have gone up by 36 percent; in sharp contrast, individual income taxes levied by subnational levels of government have risen by 67 percent. While the Federal government collected 92 percent of all individual income taxes in 1980, its share of the total had dropped to 83 percent in 1985.

Emphasis on Nontax Revenues

Looking at the mix of taxes over the past quarter of a century, Tax Foundation analysts call attention to several major shifts. Revenues from nontax sources have risen from 17.3 cents per revenue dollar in 1960 to 25.1 cents in 1985; tax revenues dropped from 82.7 cents per dollar in 1960 to 74.9 cents in 1985. Nontax revenues in 1975 were over 13 times their size in 1969; tax revenues were about eight times their 1969 levels.

Social security payroll taxes were the fastest growing of all tax sources during the period, rising from 7.0 cents per revenue dollar in 1969 to 16.7 cents in 1975. Social security tax collections in 1985 were over 22 times as large as in 1960.

State and local general sales taxes were the only other tax source showing a rising trend during the 25 years. Their share of the total increased from 3.5 cents per dollar in 1960 to 5.9 cents in 1985. Fiscal year 1985 revenue from general sales taxes exceeded $84 billion, 16 times their 1960 levels.

Tax sources showing a declining role in the structure were property, selective sales and excises, corporate profits taxes, and miscellaneous taxes.

Numbers on government revenues understate the amount spent by government in 1985 by $163 billion. The Federal government financed more than one-fifth of its outlays — $225 billion worth — by borrowing. State and local governments, on the other hand, took in $62 billion (9 percent) more than they spent, thus reducing the deficit for all governments combined to $163 billion, or 10 cents per dollar of spending. The fiscal 1985 deficit for all governments was more than six times the amount shown in 1980, and 35 percent larger than the deficit recorded in 1984.

Additional details appear in the accompanying table on page 2.

(SPENDING EACH DOLLAR, *from page 2*)
percentages for social welfare spending actually understate what could be considered the "true" social spending total, according to economists at the Tax Foundation. Broadly defined, social welfare might include public education (shown separately in the table on page 2), as well as subsidized housing and many veterans' services that are included in and not segregable from the totals of other spending categories.

Dominance of Social Welfare Spending

During the 1960s and 1970s, the social welfare programs saw a major increase in the proportion of spending being devoted to them, rising from 20.6 cents per dollar of spending in 1960 to 33.6 cents in 1980. By contrast, national defense and international relations spending fell to only 15.6 cents per dollar in 1980 from the 1960 level of 32.3 cents.

Although data for the early 1980s show a modest 2.7 cents-per-dollar increase in the spending share for defense, this outlay category pales by comparison with growth in social spending for the last quarter century. Spending on social programs in 1985 came to 16 times what it had been in 1960, whereas all other programs combined, including defense, increased by just nine times over the same period.

Education Spending Down While Debt Payments Rise

Another notable recent trend has been a relative decline in education spending, which rose to 16.7 cents per dollar of spending in 1970, but by 1985 had fallen back almost to its 1960 level (13.0 cents in 1985 compared to 12.8 cents in 1960).

Interest payments on government debt consumed 10.9 cents per dollar spent in 1985 compared to a smaller 7.9 cent bite in 1980 and 6.2 cents in 1960. Debt-related outlays have been the fastest growing cost to government in recent years.

The four largest spending categories—major social programs, defense and international relations, education and interest—accounted for nearly $1.2 trillion, or 74.1 cents of every dollar of Federal, state, and local expenditure in 1985.

The table on page 2 provides further details.

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